Administrative Receivership and Administration — An Analysis

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ABSTRACT

This paper argues that the Enterprise Act 2002 has changed the way those dealing with distressed companies are required to behave much more significantly than most commentators realise. The motivation for this change lies in the ways in which administrative receivership is destructive of social value (in terms of unnecessary job losses and other resource misallocations). The paper identifies three such ways, all linked with the fact that receivership ties the office-holder's duties to the interests of the debtor's main bank. This is undesirable because the bank (a) is usually oversecured and thus has little incentive, once receivership is underway, to ensure that financially distressed companies would not needlessly be wound up or their businesses liquidated, (b) has the benefit of directors' guarantees, which weakens its incentives to ensure the maximisation of the value of the company's business even in those cases where its proprietary security is insufficient to cover what it is owed, and (c) has little incentive in either of these cases to control the costs of receiver wastefulness or negligence. These problems are compounded by the fact that the supply side of the market for banking services to SMEs is significantly monopolistic.

In order to remedy these defects, Parliament has now imposed upon the administrator the duty to attempt a company or business rescue, as appropriate, if either one is in the interests of the creditors as a group. This duty is an objective one, is subject to the rationality test, and requires the administrator to account for his decision about which objective (company or business rescue) is to be pursued. The paper provides an understanding of company rescue consistent with the explicit text and legislative history of the statute, and discusses the importance of the quality of the company's pre-distress management to the administrator's decision about whether to attempt such a rescue.

Finally, the mechanisms provided by the statue for an aggrieved party to hold the administrator to account are discussed. The paper highlights the importance of three factors. (a) Most administrators will be appointed by the company's main bank. (b) The Insolvency Practitioners who act as administrators would be the same individuals who have acted in the past as administrative receivers. (c) There has been a paucity of understanding amongst the professionals, lawyers and accountants, about the significance of the changes brought about by the Enterprise Act. The administrator's statutory duties to act in the interests of all the creditors as a group and to act with reasonable speed and efficiency are examined in the light of these observations.

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1. INTRODUCTION

There are reasons to believe that the Enterprise Act 2002 has revolutionised corporate insolvency law. But if that is the case, the revolution is a relatively quiet one. Many insolvency professionals — lawyers and accountants alike — have not even sensed that the existing order has been overthrown. They imagine that the new administration procedure introduced by the Act merely disguises administrative receivership so as to render it more generally acceptable. They think that while requiring them to jump through some additional but merely formal hoops, the statute benignly allows them to conduct business as usual under a new name.[1] This paper argues that they are wrong. Their mistake has several complex reasons. Here are the most fundamental ones.

First, there is widespread ignorance about the harmful effects of receivership. Many still hold on to the Panglossian view that despite all the worries about it,[2] receivership is the best system on offer. This leads them to think that not much benefit can be expected from moving away from it. Second, there is considerable confusion about what the new administration procedure requires. A lot has been said about how successfully various interest groups extracted concessions in the design of the new procedure from the Government. What is overlooked, however, is that these concessions were mostly about the *appointment* of the administrator. It is true that banks extracted the right to make out-of-court appointments of administrators. However, the substance of the administrator's *duties* emerged virtually undiluted from the original proposals. In particular, Parliament has now provided an hierarchical list of objectives that each administration must pursue. And importantly, it has imposed upon the administrator a duty to explain his reasons for pursuing lower-priority objectives. Third, the administrator's decision on this point has been made subject to the rationality test. These three factors combine to revolutionise completely the way the law in this jurisdiction has dealt with distressed companies in the past. However, the significance of this potent combination of changes has been missed because this legislation has been scrutinised only by company and commercial lawyers, whereas the statutory mechanisms bringing them about derive their force mainly from drawing on principles developed by public law.

This paper has four aims. It begins by explaining why there needs to be a corporate 'rescue' mechanism such as administration at all as a supplement to the simpler and better understood liquidation procedure. Second, it explains the Government's motivation in moving away from administrative receivership. This is done by examining the relevant empirical evidence to understand the way in which receivership operates. Ignorance of this evidence and about how to interpret it is, in my view, the main cause of the continuing insistence, especially by insolvency practitioners (IPs), that receivership was a wonderful institution whose virtual demise is something to be regretted. I will argue instead that this demise was long overdue and ought to be celebrated. The paper then homes in on three of the most important features of the new law. It asks whether the administrator's duty to select a purpose for the administration is a subjective or an objective one. It explains how the administrator might justifiably choose which objective to pursue. And it throws light on potential challenges to the administrator's decisions and actions. It does so by examining the general, overriding duties imposed on the administrator and the conflicts of interest he can be expected to face.

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[1] So e.g., the changes to corporate insolvency law brought about by the Act have been described as "largely procedural"; Mark Andrews, "The Enterprise Act: sink or spin?" *Recovery* (Autumn 2003), 3.

[2] Reflected, e.g., in a thoughtful lecture by Sir Gavin Lightman, "The Challenges Ahead: Address to the Insolvency Lawyers' Association" (1996) JIBL 113.

Let me start by setting the terms of the discussion. We are mainly concerned with two formal procedures dealing with corporate distress. Under the pre-Enterprise Act law, *administrative receivership* is the preferred mode of debt enforcement against distressed companies by banks holding fixed and floating charges over substantially the entire estate of the debtor.[3] The debenture creating these charges reserves to the chargee the right to appoint an IP to manage the company and apply either its income, or the proceeds of sale of the company's business, towards the discharge of the secured debt. Perhaps the most distinctive feature of receivership is the fact that the receiver — while regarded as the debtor's agent — owes his primary (in some important respects, exclusive) obligations to the chargee.[4] He may choose to deal with the company or its assets in a way that directly inflicts harm on junior claimants, as long as he acts in good faith in the chargee's interests.[5] While security packages carrying the right to appoint an administrative receiver are held by a variety of creditors, banks and other financial institutions are by far the most important players in this respect, so it would be convenient to refer to creditors holding such global security generically as 'banks'.

By contrast, the *administration* procedure introduced by the Enterprise Act[6] entails the appointment of an Insolvency Practitioner (a) either out of court by a creditor holding global security (including a floating charge)[7] or the company or its directors,[8] or (b) by court order at the behest of the company, its directors or any of its creditors.[9] Regardless of the manner of his appointment, the administrator is an officer of the court,[10] is under a primary obligation to act in the interests of all the creditors as a whole,[11] and to perform his functions with reasonable speed and efficiency.[12]

2. WHAT SHOULD 'RESCUE' PROCEDURES BE DOING?

So why should there be a corporate 'rescue' mechanism like administration (or even receivership)? When a company becomes unable to pay its debts as they become due,[13] why not send it into liquidation straight away? It promised to pay back what it was borrowing, and now is unable to do so. So why not wind it up? This question is usually answered by drawing a distinction between financial distress and economic distress. In some cases, the net present worth of the troubled company's business as a going concern is less than the value of its assets broken up and sold separately. This means the business is not viable any more, or in other words, it has

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[3] Insolvency Act 1986, s. 29(2).
[4] See *Downsview Nominees Ltd v. First City Corporation Ltd* [1993] AC 295; compare *Medforth v Blake* [2000] Ch 86; but see now *Silven Properties Ltd v Royal Bank of Scotland* [2003] EWCA Civ 1409 (CA).
[5] For a recent example, see *Silven Properties Ltd v Royal Bank of Scotland* [2003] EWCA Civ 1409 (CA).
[6] For a description and analysis of the pre-Enterprise Act equivalent, see Roy Goode, *Principles of Corporate Insolvency Law* (London: Sweet & Maxwell, 1997, 2nd ed.), Ch. 10.
[7] Insolvency Act 1986, Sch B1 (all references to paragraphs are to paragraphs of this Schedule, unless otherwise stated), paras 14-18. The statute refers to creditors with the benefit of such a security package as 'holders of a qualifying floating charge'. For a consideration of whether it any longer makes sense to tie the right to appoint an administrator with having the benefit of a floating charge, see Mokal, 'The Floating Charge — An Elegy', in Sarah Worthington (ed), *Commercial Law and Commercial Practice* (Oxford: Hart, 2003), 479, Section VI.
[8] Paras 22-30.
[9] Paras 10-13.
[10] Para 5.
[11] Para 3(2), subject to para 3(4); discussed below.
[12] Para 4; discussed below.
[13] Insolvency Act 1986 (IA), s. 123.

become *economically distressed*.[14] The longer the assets constituting it remain harnessed to their current use, the more money that will be lost by all those with claims against the company as a group. In such cases, we can see that attempting to save the company or its business as a going concern is out of the question. Doing so would not, *ex hypothesi*, be in the interests of the company's creditors as a whole.[15] And even more explicitly, attempting to save the business would not be likely to achieve a better result for the creditors as a whole than would be likely if the company were wound up.[16] So here, the purpose of formal insolvency proceedings should be to realise the company's property in order to make a distribution to its creditors.[17]

Alternatively, the company might only be in *financial distress*. This is another way of saying it is cash-flow insolvent, which means simply that it is unable to pay its debts as they arise. This is deemed to be the case if the company fails upon demand to repay a debt of at least £750 that has become due.[18] A company which is *only* financially distressed is economically viable, and its assets might be in their highest value use. However, because these assets happen to be illiquid and because large debt repayments are looming, say, it might be rendered incapable of meeting these obligations. In this case, the purpose of the insolvency proceedings should be to save either the company (about which more later) or its business as a going concern. Given its essential viability, dismantling the business would not be in the interests of the company's creditors, since to break up the assets would be to withdraw them from their highest value use and apply them towards inferior projects.[19]

In the remainder of this paper, then, these are the main standards by which the relevant insolvency procedures will be judged. While of course ensuring a quick liquidation of the assets of *economically* distressed companies so that those assets may move to more socially useful projects, do these procedures encourage companies that are merely *financially* distressed to be given another chance? The answer is important. A procedure that allows too many such companies to be liquidated is contributing to unnecessary job losses and the misallocation of social resources.

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[14] It is important to emphasise here that companies which are economically distressed might still be able to continue trading. This is because the notion of economic distress takes into account the return to *all* the productive services constituting the firm (traditionally categorised as land, labour, capital and entrepreneurship). If the net returns provided by the firm to these services together is below what they would receive in the market, then the firm is economically distressed. However, such a firm could continue to pay its creditors on time and in full while, say, providing lower-than-market level profits to the entrepreneur or lower-than-market wages to its employees (who nevertheless remain with the firm for idiosyncratic reasons). So the point made in the text here should be understood as applying to economically distressed companies which are also *troubled*, in the sense of facing problems meeting their debt obligations. The reason is easy to understand. It is only when a company is troubled in this sense that it is likely to end up in a formal insolvency proceeding like administration.

[15] Under the Enterprise Act, compare para 3(2).

[16] Compare para 3(1)(b).

[17] Compare para 3(1)(c). Another way of saying the same thing is that for the purposes of the Enterprise Act, economic distress should, in general, mark the boundary between the first two potential purposes of administration (preservation of the company or its business as a going concern, respectively) and the third one (piecemeal liquidation of its assets). It follows that before the administrator can fix the third objective as the one he will pursue, he should have reached the conclusion that the company is in economic distress.

[18] See para 111 and s. 123 of the Insolvency Act 1986.

[19] Compare para 3(3). For a financially distressed company, the question is whether it is reasonably practicable and in the creditors' interests to save the company itself, or merely its business.

3. THE HARM DONE BY ADMINISTRATIVE RECEIVERSHIP

It is because administrative receivership was regarded as not giving troubled but essentially viable companies or businesses a sufficient chance to be rescued that the Enterprise Act has severely restricted its availability. In the White Paper preceding the Act, the Government noted "widespread concern as to the extent to which… receivership as a procedure provides adequate incentives to maximise economic value" by helping out distressed but viable businesses. The ability of the floating charge holder to block administration by appointing a receiver was taken as an important reason for the low uptake of administration. This was regarded as undesirable because (even) the old administration procedure was a self-consciously 'rescue'-oriented mechanism. The White Paper also highlighted concern about whether receivership provided "an acceptable level of transparency and accountability to the range of stakeholders with an interest in a company's affairs, particularly creditors."[20]

The way in which the Enterprise Act seeks to address these concerns is examined below. Before that, however, we must ask whether the Government was right to accept that receivership was inadequate both as a recovery mechanism and in providing transparency and accountability for junior claimants (viz., those ranking behind the security-holding bank in the distribution of value from the insolvent estate). We must ask these questions because the Government provided no evidence that this was *in fact* the case, and because several commentators have strenuously rejected such slurs on receivership.[21] Also, if receivership was doing a good job in rescuing businesses, then the massive costs of consultation, legislation and displacement of familiar legal institutions and practices were and are entirely unjustified. What is more, the new administration procedure involves mechanisms of consultation and accountability to a variety of claimants which stand in stark contrast to the receiver's single-minded dedication to the bank's interests. Keeping that in mind, suppose that the law governing receivership was efficient in rescuing viable businesses and doing so cost-effectively. In that case, the switch to administration will increase the costs borne by the claimants as a group (as the administrator goes about complying with his more demanding duties to a broader range of stakeholders) while bringing (*ex hypothesi*) few additional benefits in terms of additional businesses saved from unnecessary liquidation.

a. Business or Company: What Should be Rescued?

Therefore, it is worth looking a little more carefully at the expressed rationales for the reforms. In relation first to the 'rescue culture', does the low take-up of administration necessarily mean that 'rescues' do not occur? In order to answer this question, we need to be clear about what constitutes corporate rescue. It is important here to distinguish between a company, the legal entity that is created for the purpose of carrying on a business, and the productive assets constituting that business itself. The *company* does not itself make products, create jobs, or produce revenues. That is what the actual *business* is all about. So on one understanding of

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[20] White Paper, *Productivity and Enterprise - Insolvency: A Second Chance* (London: HMSO, 2001), para 2.2.

[21] The British Bankers' Association claims that there is "no evidence that debenture holders destroy viable companies through over-hasty appointment of receivers", and that "receivership is a very successful method to transfer a business to new investors"; *BBA Response to the Report by the Review Group on Company Rescue and Business Reconstruction Mechanisms,* available at the URL: <http://www.bba.org.uk/public/newsroom/35451/3651?version=1>. The objections to receivership were described as "dogma" in an Editorial in the Insolvency Practitioners' main trade journal; see *Recovery* (Autumn 2003), 2. For the most persuasive and coherent academic defence of receivership, see John Armour and Sandra Frisby, "Rethinking receivership" (2001) 21 OJLS 73.

'corporate rescue', all that is required is that assets which are more valuable as a cohesive productive unit than they would be if split apart and sold off piecemeal, should in fact be kept together. The business can continue to trade either under the ownership of the original corporate entity *or* through the sale of the productive assets as a going concern. Now whilst administrative receivership necessitates the closure of the corporate entity, its defenders endlessly point out that this does not necessarily imply the closure of the business. The available empirical data suggest that a significant proportion of receiverships result in *business* rescue. Indeed, under the old law — where administration was deliberately designed as a secondary mechanism to cover situations where receivership would not be available[22] — this proportion was comparable to that achieved in administration.[23] On this view of 'corporate rescue', it would appear misleading to suggest that the ability of a floating charge holder to block the appointment of an administrator impedes the successful operation of the 'rescue culture'.

We should not stop here, however.[24] There is a more demanding notion of 'corporate rescue', where some value is placed on the preservation of the old corporate entity itself. Here is one understanding of *company rescue* that, I submit, is implied by the Government's statements about its intentions during the legislative process, and which is also meaningfully different from the sort of business rescue discussed above. The company is rescued as a going concern if the original legal entity continues to own all or at least a significant part of its pre-distress business. In practice, this would generally be a concomitant of a bargain or agreement whereby the shares in it, or at least a significant proportion of them, come to be owned by some combination of its original, pre-distress creditors and shareholders. Here is the intuition underlying this conception of corporate rescue. The primary determinant of whether to aim for a *company* rescue as opposed to a mere *business* rescue is whether a market sale of the company's assets is desirable. If it is not, then it would be in the interests of all the claimants as a group for those assets to (in effect) be sold to the company's pre-distress creditors and/or its pre-distress shareholders by way of a Company Voluntary Arrangement (CVA), scheme of arrangement or composition. This brings about a company rescue. A market sale of the company's assets might not be desirable in either or

[22] The Cork Committee recommended the introduction of administration as a substitute for administrative receivership for companies that had not granted a floating charge to a bank or other secured creditor. The veto power given to the floating charge holder over the commencement of administration merely reflected the original conception of administration as a secondary route, which would only be pursued where no floating charge was in existence. See the Insolvency Law Review Committee, *Insolvency Law and Practice* (Cmnd. 8558, 1982), Ch. 9.

[23] See the figures in the Association of Business Recovery Professionals' *R3 9th Survey of Business Recovery in the UK* (London: ABRP, 2000), 17. Very importantly, however, given the skewed way in which companies would end up in administration (viz., only when they were allowed to do so by the very party entitled to initiate receivership), the meaningfulness of comparisons between business rescue rates in receivership and pre-Enterprise Act administration is open to very serious doubt.

[24] It is surprising to see how tempted some commentators have been to do so. The British Bankers Association probably went the furthest in expressing exaggerated incomprehension even as to the *possibility* that rescue procedures could have any other purpose: "We… assume that there is a typographical error in the suggestion [contained in the Report by the Review Group on Company Rescue and Business Reconstruction Mechanisms] that the primary object of rescue is companies rather than businesses"! See *BBA Response to the Report by the Review Group on Company Rescue and Business Reconstruction Mechanisms,* available at the URL: <http://www.bba.org.uk/public/newsroom/35451/3651?version=1>. A similar note of incredulity mixed with sarcasm can be detected (though with some exceptions) in the pages of *Recovery*. The suggestion that *companies* rather than merely businesses might be worthy of rescue has been described as "the government's hang-up" (*Rescue*, Spring 2003, 31), and being based on little more than a "surprisingly steadfast lack of distinction between the company and its business" (*Rescue*, Autumn 2003, 2).

both of two situations: (a) The market for those assets might lack liquidity.[25] Or, overlapping with this, (b) it might be necessary, in order to derive the best value from those assets, to make them available to those with accumulated expertise in their use. This argues in favour of retaining (some of) the pre-distress managers of the company, who would often also be the company's pre-distress shareholders.[26] What constitutes a 'significant' proportion (of business and of shares) for this purpose, and what combination of pre-distress creditors and shareholders end up being shareholders in the 'rescued' entity, would of course depend upon the circumstances of the case.[27] What matters is that the original legal entity survives, and that it survives as a commercially trading entity. I submit that this is the notion of corporate rescue enshrined in the new administration procedure.[28]

It is further submitted that this is justifiable for several reasons, only two of which will be mentioned here. First, the new procedure may now be invoked by the bank of a distressed company without any need to demonstrate the company's insolvency.[29] For reasons I have explained elsewhere,[30] this is beneficial for all those interested in the company's undertaking. This fact also opens up the possibility, however, that the company placed in administration, while distressed, is still solvent. By definition here, the company's shareholders have a real interest in the proceedings, which should be substantively recognised in the procedure by opening up the possibility that the company itself would be rescued as a going concern in the sense outlined here. Second and taking the same reasoning forward, it would often be the case that the company's directors are in the best position to sense impending crisis. There is great value in providing incentives — 'sticks and carrots' — for them to take action at that point. For whatever it is worth, the 'stick' already exists in the form of the wrongful trading provisions in section 214 of the Insolvency Act 1986.[31] One way of providing the 'carrots' would be to ensure that the directors — who, for companies most likely to become subject to administration, would also be significant shareholders — would have some hope of regaining control and residual claimant status if they act at the earliest appropriate moment. A procedure which aims in the first instance at company rescue could be expected to provide them the right incentives.[32]

b. How Good was Administrative Receivership even in Rescuing Businesses?

Turning secondly to the concern with the 'inefficiency' of administrative receivership: it is undoubtedly the case that a senior creditor — such as a bank — may have perverse incentives to close down a distressed business 'too quickly'. These perverse incentives arise most obviously where the bank is 'oversecured': in other words, where the value of the assets subject to its

[25] This and similar factors are discussed in John Armour and Rizwaan J. Mokal, "Reforming the Governance of Corporate Rescue: The Enterprise Act 2002" (forthcoming).
[26] This is discussed below.
[27] In many equity-for-debt swaps, for example, the original shareholders might end up with little or nothing of the post-administration company's equity.
[28] See para 3(1)(a).
[29] Paras 16 (out of court appointment) and 35(2)(a) (appointment by court order).
[30] Mokal, 'The Floating Charge', Section III.
[31] For an analysis, see R. Mokal, "An Agency Cost Analysis of the Wrongful Trading Provisions" [2000] CLJ 335.
[32] This was explicitly given as the reason for this feature of the Act; see Mr. Douglas Alexander, Minister for E-Commerce and Competitiveness, Hansard, 10 April : Column 549; see also Lord McIntosh of Haringey, 29 July : Column 766. How tempting this carrot proves is however another question; see John Armour and Rizwaan J. Mokal, "Reforming the Governance of Corporate Rescue: The Enterprise Act 2002" (forthcoming).

charges is greater, however they are sought to be realised, than the amount owed to the bank.[33] In this case, the bank will be concerned primarily with how quickly the assets can be sold, as opposed to selling them in the way that will produce the greatest returns overall. Yet if the bank is not oversecured, it might be thought that the perverse incentive vanishes. For example, if the bank is owed £100,000, and the assets will realise £80,000 on a break-up basis but £120,000 in a going-concern sale, then the bank will prefer a going-concern sale regardless of whether this takes longer.[34] The extent of the perverse incentive problem is therefore an empirical question, depending on the relative frequency with which banks find themselves 'oversecured' and 'undersecured'. Now it is generally recognised that banks are often undersecured in insolvency proceedings.[35] This is supported by the results of the Association of Business Recovery Professionals' ('APRB') survey of its members, which reports that the average recovery by secured creditors — across all types of insolvency procedure — in 1997-98 was only 37% of the face value of their debt, and in 1998-99, 53%.[36] If banks do not recover in full, then it might be said they are by definition undersecured. It might therefore appear that the perceived inefficiency of administrative receivership had been significantly overstated.

However, this conclusion would be erroneous. There are several reasons to think essentially viable businesses are frequently closed down under the receivership system. First, note that it is less useful to look at the *mean* recoveries of banks, and quite crucial to examine the *proportion* of receiverships in which banks are oversecured.[37] It is easy to understand why. In any particular case, the bank is either under- or oversecured. In cases where the bank is undersecured, let us grant (contrary to what will be argued next) that the receiver has the right incentives to maximise value anyway. Consideration of the bank's average returns is therefore irrelevant. On the other hand, where the bank is oversecured, ruminating over the bank's average returns over thousands of insolvencies is unlikely to provide the receiver with additional reasons in *this particular one* to maximise value beyond the point at which the bank recovers fully. So the decisions of receivers, acting primarily on the bank's behalf, are predominantly affected not by the bank's average recoveries over many insolvencies, but by how much the bank is likely to recover in the particular receivership the receiver is conducting. It is that assessment which shapes their incentives about whether to go for an overly hasty 'fire-sale' of the business or its constituent assets.

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[33] See J Armour and S Frisby, 'Rethinking Receivership' (2001) 21*Oxford Journal of Legal Studies* 73, 90.

[34] This is of course subject to the observation that, despite his obligation to obtain a "fair" or "proper" value when disposing of the charged assets, the receiver has little incentive to bargain for a price over and above that required to meet the bank's claim and his own costs. Remember that going concern sales are often all about sensing the movements of and searching through the market, and then about bargaining to obtain the best price available. In short, going concerns sales are about the right timing. However, the receiver is under no obligation to junior claimants with respect to the timing of the sale; *Silven Properties Ltd v Royal Bank of Scotland* [2003] EWCA Civ 1409 (CA). So on the facts assumed in the text, (a) if the receivership costs are fixed at, say, £12,000, then the receiver has no incentive to search for and bargain towards a price higher than £112,000, which results in a loss of £8,000 to junior claimants (at least, since there might also be losses of idiosyncratic value), and (b) if the costs are not fixed in some way, the receiver would have an incentive to realise the assets at a higher price as long as he could capture the additional returns by inflating his costs. This is discussed further in the text, below.

[35] Armour and Frisby, "Rethinking Receivership", 96.

[36] Society of Practitioners of Insolvency, *8th Survey of Company Insolvency in the United Kingdom* (London: SPI, 1999), 14-15; Association of Business Recovery Professionals, *R3 9th Survey of Business Recovery in the UK* (London: ABRP, 2000), 18. However, *cf* Julian Franks and Oren Sussman, *The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies* (London: IFA Working Paper 306-2000, 2000) (hereafter, *Cycle*), 14.

[37] Another way of making this point is to say that what matters is not so much the *means* as the *medians* of banks' recoveries in receivership.

Looked at in this way, the position changes dramatically. Evidence, including that given on behalf of the banks themselves, indicates that they are oversecured in over half of all receiverships.[38] From what has been said above, it follows that acting on the bank's behalf, receivers do not have the correct incentives to maximise value in over half of cases.[39] On this evidence alone, receivership starts looking like a highly value-destructive institution: one in every two receiverships potentially allows a viable business to be broken up. It is hard to overstate the significance of this conclusion. As a mechanism for generating the correct incentives for the prevention of unnecessary job losses and resource misallocation, receivership is — on the facts as admitted by the banks themselves — as reliable as the toss of a coin.

In fact, things are worse even than this. The second reason for thinking that receiverships are socially harmful has a broader ambit yet. Remember that banks have often taken alternative forms of security to cover the debt owed to them. Most notably for our purposes, they extract personal guarantees from the shareholder-directors of over half the firms to which they lend.[40] Where such security has been provided, the receiver would have less incentive to ensure a value-maximising disposal of the business, even in those cases where the bank is undersecured. Acting primarily in the bank's interests, he will expend time and resources attempting to seek a value-maximising disposal of the business to the point where the net addition to the bank's overall recovery from doing so equals the net addition to that recovery through a personal action by the bank against the surety-directors. This effect is strengthened by another important factor: other things being equal, banks are likely to extract personal guarantees from directors *precisely* in those cases where they expect to end up undersecured. It follows that some value would be lost in overly hasty fire-sales even when the bank is not oversecured.[41]

c. The direct costs of receivership

We should also consider the direct costs of the process of receivership. For a long time, one of the main defences made of this mechanism was that it takes less time and costs less money. We now

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[38] See British Bankers' Association, *BBA Response to the Report by the Review Group on Company Rescue and Business Reconstruction Mechanisms,* ('Our own experience suggests that we obtain full recovery in something nearer to 50% of [receivership] cases'). This is reinforced by the finding by Franks and Sussman that the *median* recovery in receivership for one of the banks in their study was 100%; *Cycle*, 14. Even more directly, they found that the figures available *ex ante* to the banks themselves indicate that banks are generally (though not invariably) oversecured; see *Cycle*, p. 9, which shows that the collateral held by the banks as a proportion of what they were owed was 103.7%, 74.6% and 118.5%. Older, less reliable evidence — because it is based on surveys of insolvency practitioners rather than on the banks' records — comes from SPI (now, the ABRP), which reports that banks recovered fully in 19% of receiverships; *8th Survey*, 4.

[39] Even the less reliable ABRP figure suggests receivers are under-incentivised in around a fifth of all cases — not exactly a negligible proportion.

[40] *Cycle*, 9; the figures are 60.4%, 51% and 55% for the three banks.

[41] Importantly, another effect of the existence of director guarantees is the contribution they make to the control of *director* misbehaviour. This leads to a decrease in the probability that a business would become distressed in the first place and thus enhances the value of all the claims against the company. This is explained in Mokal, 'The Search for Someone to Save' [2002] OJLS 687, and especially at 697-8, 708-15 and 721-7. It is of course an empirical question whether the social loss resulting from the first effect (fire-sales of viable businesses) is greater or smaller than the social gain resulting from the second (control of director misbehaviour). Either way, some viable firms are closed down because the primary beneficiary of receivers' duties has alternative ways of claiming on the debt owed to it. We therefore have reason to consider alternatives to receivership that would allow the positive effects of directors' guarantees to persist while reducing the perverse incentives of the IP responsible for dealing with a distressed business.

know that this popular prejudice was just that: a prejudice.[42] Receivership might have been quick but it was certainly not cheap. The procedure costs *on average* up to a quarter of the value of the insolvent estate.[43] I have pointed out elsewhere that a process that consumes such a large proportion of the estate it is meant to be distributing to a pre-determined group of claimants is intrinsically absurd.[44] The process sold for being cheap is hugely more expensive than comparable procedures elsewhere. It would be illustrative to make some quick international comparisons. Notice the distinction between 'debtor-in-possession' systems where the pre-distress management is left in charge of the company during the formal insolvency proceedings, and 'management displacement' systems where the pre-distress management is deposed or its powers suspended in favour of an outside expert (official or private). As a starting point, we can expect management displacement regimes to involve greater *direct* costs, incurred because of the employment of the new, distress-oriented manager.[45] Keeping this in mind, it would be fruitful to compare both types of regime with receivership. Receivership itself is of course a management displacement regime, so let us take such systems first. A well-known study reported results for a Swedish regime dealing with corporate distress. Here, the initiation of the formal proceedings immediately displaces the management in favour of a court-appointed trustee who owes fiduciary obligations to creditors. In this system, and for companies of a comparable size and other characteristics similar to those undergoing receivership in this jurisdiction, the total direct costs of the proceedings (including lawyers' and consulting fees and administrative costs) is 13.2% (median) of the value of the distressed company's estate.[46] And under a similar Finnish regime, a study of rescue proceedings concerning comparable companies showed that the total direct costs of the proceedings are 14.7% (median).[47] Turning now to the most famous debtor-in-possession regime, and focussing once again on companies with characteristics similar to those undergoing receivership, the figure for total direct costs in US Bankruptcy Code Chapter 11 proceedings is 4.7% (median).[48]

In view of the empirical evidence discussed above, this should come as no surprise. Receivers owe primary obligations to banks. Banks are concerned with ensuring high recoveries for themselves. They recover fully in around half of receiverships. In many — perhaps most — others, they have methods of recovery (like directors' guarantees) that do not require the

[42] Nor was this prejudice universally shared; see e.g. G. Lightman, "The Challenges Ahead", 113-116.
[43] *Cycle*, 14; Julian Franks and Oren Sussman, 'Resolving financial distress by way of a contract: An empirical study of small UK companies' (22 October, 2000), available at URL: www.ifk-cfs.de/papers/franks.pdf, p. 19. This is a median figure, in recognition of the great variability of the findings. For the sake of completeness, the means for the costs for the three banks studied were 42.4%, 24.3% and 38.7%; "Resolving", Table 3, Panel D.
[44] Mokal, "The Floating Charge", 497.
[45] Note however that the retention of pre-distress managers during the insolvency proceedings might create other problems, e.g. a bias in favour of rescue attempts even when the troubled company is economically distressed so that the rescue is doomed to failure, or where the company, while viable, has been brought into distress precisely because of the incompetence of its managers. The point is that while the *direct* costs of debtor-in-possession systems might be lower than those of management displacement ones, the *overall* costs to society of failed rescues or the continuation of economically distressed companies might well be higher.
[46] Karin Thornburn, "Bankruptcy Auctions: Costs, Debt Recovery and Firm Survival" (2000) 58 Journal of Financial Economics 337, 355.
[47] Abraham Ravid and Stefan Sundgren, "The Comparative Efficiency of Small-Firm Bankruptcies: A Study of the US and Finnish Bankruptcy Codes" (1998) 27 Financial Management 28, Section IV.
[48] Stephen Ferris and Robert Lawless, "The Expenses of Financial Distress: The Direct Costs Of Chapter 11" (2000) 61 University of Pittsburgh Law Review 629, 651. This is consistent with our initial surmise that the direct costs of debtor-in-possession systems would be lower than those of management displacement ones.

maximisation of the value, net of costs, of the insolvent estate. So beyond the point at which the bank recovers fully, the costs of the receiver's actions — including grossly wasteful or negligent ones — falls not on the bank but on junior claimants. Junior claimants, however, while obviously affected by his actions, cannot hold the receiver to account.[49] They are vulnerable to gratuitous harm[50] inflicted by someone dealing with what in effect is *their* property[51] without having any meaningful remedy against him… a situation unknown to the law except in this domain![52] And lest it be thought this suggestion of receiver wastefulness is merely theoretical, there is in fact strong empirical support for it. Evidence indicates that when receiverships are tendered out, costs fall dramatically, to around 14.5%.[53] Notice that this figure is very much in line with that reported above for other management displacement regimes. The effect of tendering out receiverships is of course to focus the burden of any wasteful behaviour onto the insolvency practitioner concerned. The striking reduction in costs — and the fact that the reduced costs align closely with those in systems where the outside manager owes duties to *all* the creditors — therefore indicates the extent to which the expenses of receivership (of the usual non-tendered out variety) are inflated because of receiver wastefulness.

Arguably, Parliament saw the potential for just this type of motivation cost to be acute in the institution of receivership when it provided a power for the liquidator to approach the court to set the receiver's remuneration.[54] However, the courts (here as in so much else to do with receivership) destroyed the usefulness of this provision by insisting that they would only intervene if the level of remuneration set in the debenture was plainly excessive.[55] Given that standard terms in debentures provide that the receiver's remuneration would be fixed by reference to the charging practices of the receiver's firm,[56] and given also that the motivation costs mentioned above could be expected to be endemic within the institution of receivership regardless of the receiver's firm,[57] the practical effect of this approach was to render the statutory provisions nugatory.[58]

d. Receiver opportunism

Receivers are also now known to engage in opportunistic behaviour on behalf of their appointor by attributing some costs to the floating charge instead of the fixed one, with a view to inflating the recoveries under the latter.[59] This is a practice which does cause loss to be moved from the

[49] See now *Silven Properties Ltd v Royal Bank of Scotland* [2003] EWCA Civ 1409.
[50] 'Gratuitous harm' in the sense that its infliction is not required, on any reasonable view, in order for the receiver to obtain the best outcome for his appointor. A recent example is provided both by the facts and the decision in *Silven Properties Ltd v Royal Bank of Scotland*.
[51] See e.g. *West Mercia Safetywear Ltd. (in liq.) v Dodd* [1988] B.C.L.C. 250, 252-3 and IA, s. 214 etc.
[52] Contrast, e.g., the position of company directors, trustees, mortgagees in possession, ordinary agents dealing with their principal's property, bailees, etc.
[53] Franks and Sussman, "Resolving financial distress", 33.
[54] IA, s. 36 (this provision makes no explicit reference to indemnity or reimbursement, though the argument in the text here applies to these as much as it does to the receiver's remuneration); see also Companies Act 1948, s. 371(1).
[55] *Re Potters Oils Ltd* [1986] 1 WLR 210.
[56] Lingard, *Bank Security Documents* (London, Butterworths, 1993 3rd ed.), para. 7-04.
[57] Since the oversecured bank "without risk can afford to be generous" in agreeing costs with the receiver when they are to be paid out of money otherwise destined for "the open unguarded pocket" of the distressed company's unsecured creditors; G. Lightman, "The Challenges Ahead", 115-116.
[58] For consideration of a preferable approach, see the discussion in Section 5, below.
[59] Franks and Sussman, 'Resolving financial distress' at 18. A simple numerical illustration would help in grasping this point. Suppose that assets subject to the fixed charge are sold for £100, those subject to the

party best placed to deal with it *ex ante*,[60] to those worse placed to do so.[61] This is doubly the case since it is unpredictable *when* such behaviour might benefit the bank and when in turn a receiver might resort to it. So the fact that it might happen is unlikely to bring any (even theoretical) compensating benefits, in the form of lower interest rates from the bank, say.

e. A market solution?

Finally and most broadly, let us postulate that one of the services provided by banks is a system to reduce the sort of shirking and incompetence on part of receivers that might lead to the closure of essentially viable businesses, and receiver wastefulness that results in the inflation of costs.[62] The social value of this service exceeds its private value to the bank (a) in those cases where it is oversecured, and (b) in those cases where it is undersecured but has the benefit of directors' guarantees, beyond the point where it would find it cheaper to pursue a personal claim against the directors than to ensure a value-maximising disposal of the business. The bank charges for this service by adding a premium to the cost of credit. Companies have an incentive to pay this premium because, as noted, their directors have often guaranteed the bank's debt, and because they would also have lent significant amounts to their company.[63] Therefore, they would wish to ensure that should insolvency occur, the maximum value would be squeezed out of the business. It would not necessarily matter that guarantors and junior creditors could not proceed directly against the receiver if they suspected misbehaviour (overly hasty liquidation, inflation of costs, etc.) on his part. As a group, directors in the market for this service would simply shop around for banks which had invested in building up a reputation for hiring the right sort of receivers, and in exercising an appropriate level of control over them.

At this point, however, we should notice the supply-side structure of the market in banking services in this country. This is highly uncompetitive, with the big four groups of banks exercising significant monopoly power by virtue of their control of around 80% of that market between them.[64] And under the receivership system, banks have significant monopoly power in

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floating charge fetch another £100, and the receiver's total costs are £50. Assume also that the secured creditor (holding both fixed and floating charges) and preferential creditors are owed £200 each. Recall that costs attributed to realising assets subject to the floating charge have to be paid in priority to statutory preferential debts. Suppose first that the receiver attributes half of his costs each to the realisation of fixed and floating charge assets. In this case, the secured creditor receives £75 (£100 from the sale of fixed charge assets minus the receiver's costs of £25), and preferential creditors get £75 (*mutatis mutandis*). However, if the receiver attributes only a quarter of his costs to the realisation of fixed charge assets and the rest to the realisation of floating charge ones, then the secured creditor gets £87.50 and preferential creditors receive only £62.50.

[60] Viz., the bank, which can adjust rates and other terms to compensate itself for expected losses.

[61] The Crown in right of unpaid taxes, or employees in right of back pay, etc. Such parties cannot of course adjust the terms on which they become the company's creditors.

[62] The constituents of this system would include, e.g., (a) a mechanism to pick an IP with the desired reputation, (b) a method of telling economically distressed firms apart from those which are merely financially distressed, (c) a way of verifying this to the receiver and if necessary, before a court, (d) benchmarks for the sort of costs reasonably to be expected of particular types of receivership, and (e) a method of dealing with any additional risks created by the line of authority stemming from *Re Vimbos Ltd* [1900] 1 Ch 470 in attempting to control the receiver once receivership in underway.

[63] *Cycle*, 7-8.

[64] See e.g. Don Cruikshank, *Competition in UK Banking* (London: HM Treasury, March 2000), Ch. 5, especially pp. 162-167; and the Competition Commission, *The Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises* (London: HMSO, March 2002), in particular, the Commission's conclusions on complex monopoly effects and the harm thereby done to the public interest at pp 128-130 and 137.

the provision of the service described above not only because of the structure of the market, but also (as noted) because they are the primary and often effectively the sole beneficiaries of receivers' duties. As with any good or service supplied monopolistically, the implication is that the level of monitoring etc. of receiver misbehaviour provided by banks is lower than the social optimum and the price is higher. In other words, the result is the closure of some essentially viable businesses and the inflation of receivership costs, this time because the banks exercise a less than optimal level of control over receiver shirking, incompetence and wastefulness. And the control that does exist comes at a price which destroys more consumer (junior claimant) surplus than it adds to producer (bank) surplus. These are the dead-weight costs of tying receivers' duties to banks' interests.[65]

f. Conclusions on Receivership and the Value of Enhanced Accountability

This discussion makes it clear very significant value is probably being wasted because of the perverse structure of receivership, in the form of unnecessary job losses, resource misallocation, and wastefully inflated costs. An improved mechanism for dealing with corporate distress would be geared towards salvaging this value. We can draw several lessons about the design of a less socially harmful mechanism for dealing with corporate distress. First, it would pay to orient the duties of the IP charged with ensuring a value-maximising disposal of distressed businesses towards the *true* residual legal claimants in particular insolvencies. Second, the IPs' duties should be shaped by the interests of a party not easily able to ensure repayment of its loan by means independent of (a) the maximisation of the value of the insolvent estate, and (b) the control of the costs of the mechanism. Third and distinctly, the improved system would not tie the obligations of the IP (exclusively or even primarily) to the interests of the monopoly power-wielding banks. And finally, the IP should be effectively accountable, as to the discharge of his duties, to the parties to whom the duties are owed.

Evidence suggests that the first three requirements are primarily fulfilled by the shareholder-directors of the sort of companies that most frequently become subject to formal insolvency proceedings at the present, and which could be expected to be the most frequent entrants into administration. Most such companies are small and closely held.[66] Recall that the shareholder-directors of these companies have guaranteed the bank's debt (in between 50% and 60% of receivership cases). They have also lent to their company sums that "in absolute size… may be significant" for them: evidence indicates that on average, something like 2.4% to 6% of the troubled company's debt is owed to its directors.[67] Shareholder-directors would also have made idiosyncratic investments in the company, captured by the very useful clichés 'my name is on the door', or 'this is my life's work'. Given therefore that they are likely to consider themselves deeply tied up with the fortunes of the company, and given that they would often clearly be its residual claimants, shareholder-directors have every incentive to ensure that the company's value would be maximised. A system intent on maximising the value of distressed companies and

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[65] While the analysis here is mine, this conclusion is entirely consistent with the Competition Commission's findings, referred to above.

[66] ABRP provides evidence that 80% of the companies undergoing formal insolvency proceedings had less than 14 employees, and that both the assets and the liabilities of around 90% of these companies was less than £5m. Further, only 2% of the companies engaged in an insolvency procedure were quoted on a recognised stock exchange, no share capital was held by institutional investors in 93% of the cases, and in only 2% of such proceedings had the insolvent firm benefited from a rights issue or other equity investment in the 12 months leading upto the insolvency proceedings; see *Survey of Business Recovery in the UK: 9th. Survey* (2001, available at URL: < http://www.r3.org.uk/pdf/09th_Company_survey.pdf>), pp. 7, 8, and 12.

[67] *Cycle*, pp. 7-8.

businesses would therefore orient towards them — at least presumptively — the duties of the IP presiding over the insolvency proceedings.

It is also interesting to study the position of the Crown. It is often a primary residual claimant in insolvency proceedings by virtue of the subrogation of the National Insurance Fund to a significant chunk of the preferential claims of employees,[68] and because of its claims for unpaid tax etc. As things stand, it is a 'non-adjusting' creditor, unable to exercise any influence on the size of its recoveries except by controlling IP misbehaviour and the costs of the mechanism dealing with corporate distress. And because the rates of tax, VAT and employer contributions to the National Insurance Fund etc. are not set in view of the likelihood of the insolvency of a particular company and thus of its need for monitoring of IP misbehaviour, the Crown cannot pass on its costs to any other party. It cannot therefore exploit any sort of monopoly power in the way it would exercise control over IP misbehaviour. It would therefore seem that in an improved corporate distress mechanism, the IP would be accountable to the Crown. This reasoning repeats itself (though with varying degrees of force) with respect to other parties fulfilling (to corresponding degrees) the requirements set out above.

Accountability to these parties can be increased through a variety of means: requiring that decisions be taken, or at least confirmed, by a creditors' meeting rather than the office-holder; requiring court supervision of the office-holder's performance of his functions; or by imposing duties on the office holder to take into account the interests of different groups of creditors. It is clear that none of these mechanisms is cost-free. However, I have explained above the very significant extent to which the lack of accountability in receivership can be expected to lead receivers to make decisions that fail to maximise the value realised from the sale of the company's assets and control costs. So the direct costs of increased accountability in an improved rescue procedure can be expected to be offset by savings from increased returns generated by more accountable office-holders. In addition, to the extent that a system which takes cognisance in some appropriate way of the interests of all those it affects is fairer than a system which does not, accountability is also a virtue worth pursuing precisely because it conduces to fairness.[69] And finally, the disregard in which receivership is held in other jurisdictions is both, undoubtedly genuine, and linked as well to the justified perception that it is not a 'collective' mechanism, that (*inter alia*) it does not ensure that the IP take into account the interests of all the creditors affected by his actions.[70] To the extent that value is placed in acquiring international acceptability — and respectability — for the English system of dealing with corporate distress, we get our final reason for ensuring that the system complies genuinely and substantively with the condition precedent (as it were) of gaining that acceptability.

3. THE ADMINISTRATOR'S DUTY TO CHOOSE THE OBJECTIVE OF ADMINISTRATION

Let us focus now on some of the most important aspects of the new administration procedure, starting with the administrator's duties. By far the most important decision the administrator is called upon to make, and one with the most pervasive effects, is about what objective the

[68] By virtue of the obligation of the Secretary of State, through the Redundancy Payment Service, to make payments to employees from the National Insurance Fund.
[69] See e.g. the discussion of accountability, regarded as an aspect of efficiency, and its relationship with fairness in R. Mokal, "On Fairness and Efficiency" [2003] MLR 452.
[70] See e.g. the EC Regulation on Insolvency Proceedings, conferring automatic recognition to collective insolvency proceedings throughout the European Union, but excluding administrative receivership from its ambit; Regulation 1346/2000 EC [2000] OJ L160/1, Annex A.

administration should be directed at achieving. The paragraph setting out the menu of choices deserves to be reproduced in full:

3 (1) The administrator of a company must perform his functions with the objective of-

(a) rescuing the company as a going concern, or

(b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or

(c) realising property in order to make a distribution to one or more secured or preferential creditors.

(2) Subject to sub-paragraph (4), the administrator of a company must perform his functions in the interests of the company's creditors as a whole.

(3) The administrator must perform his functions with the objective specified in sub-paragraph (1)(a) unless he thinks either-

(a) that it is not reasonably practicable to achieve that objective, or

(b) that the objective specified in sub-paragraph (1)(b) would achieve a better result for the company's creditors as a whole.

(4) The administrator may perform his functions with the objective specified in sub-paragraph (1)(c) only if-

(a) he thinks that it is not reasonably practicable to achieve either of the objectives specified in sub-paragraph (1)(a) and (b), and

(b) he does not unnecessarily harm the interests of the creditors of the company as a whole.

It is obvious that the administrator's decision on these matters will shape the entire course of administration, so it is important to understand the exact nature of his duty with respect to it. The statute speaks of his "thinking" about what would be in the collective interest of creditors or about whether a particular course of action would be reasonably practicable. Which one of the objectives the administrator may properly pursue depends on his coming to "think" that certain factors are present or absent, and that certain conditions are or are not met. So how would the administrator discharge his obligations? That he does so in an open and transparent manner was clearly regarded as important by Parliament. Paragraph 49 provides that:

49 (1) The administrator of a company shall make a statement setting out proposals for achieving the purpose of administration.

(2) [This] statement… must, in particular —…

(c) where applicable, explain why the administrator thinks that the objective mentioned in paragraph 3(1)(a) [saving the company as a going concern] or (b) [primarily, saving the business as a going concern] cannot be achieved.

So what is the cumulative effect of these provisions on the nature of the administrator's duties? In particular, must he comply with an objective or a subjective test in coming to settle upon the purpose of administration? The answer may seem to lie in the apparent subjectivity of the way in which the administrator's decision is reached: he must come to "think" that this or that state of affairs exists, that X or Y would be in the best interests of the creditors, and that outcome A is not reasonably practicable but outcome B is. For this reason, it might be thought that the administrator's duty to settle upon a purpose for the administration is of a subjective nature. The implication would then seem to be that once the administrator declares his "thinking" one way or the other, that is more or less the end of the matter (subject to questions of good faith), and that it would be very difficult to mount a challenge to his decisions on this point.

I submit that this view is erroneous.[71] First and most obviously, Parliament has provided a *hierarchy* of possible objectives, and clearly intended to prioritise company or business rescue, as appropriate, over mere realisation of the company's assets. It is for this reason that lower priority objectives are made available to the administrator *only if* an appropriate combination of the conditions listed in paragraph 3 (3) (a) and (b) and (4) (a) and (b) are satisfied.[72] Second, the apparently unregulated language of the administrator coming to "think" that these circumstances are present intersects repeatedly and meaningfully with statements, *not* phrased in terms of his "thinking", of the duties that must be complied with for there to be a proper exercise of this discretion to choose. The administrator is under an ever-present obligation not unnecessarily to harm the interests of the creditors as a whole. Note that the duty is *not* to refrain from doing what he *thinks* would harm creditors unnecessarily; rather, he must refrain from actions that, quite simply, unnecessarily harm the creditors. Subject to this, and with the exception of the situation where he thinks the achievement of neither of the two higher priority objectives is reasonably practicable, he must perform his functions in the interests of the creditors as a whole. Again, the duty is not to act merely in a way which he *thinks* is in the interests of the creditors. It is clear, then, that the administrator may only select either of the first two objectives while complying with his duty to act in the interests of creditors as a whole, and that this duty is independent of his "thinking". It is also clear that he may only choose the third objective while (among other things) complying with his duty not to inflict unnecessary harm to those interests, which duty also is independent of his "thinking". The administrator is also under an overall duty to perform his functions as quickly and efficiently as is reasonably practicable. Absent once again is any reference to his thinking.

Next, we should note that in exercising his functions, the administrator acts as the company's agent, and is required, upon appointment, to take custody or control of all of the property to which he thinks the company is entitled, and to manage the company's affairs.[73] Unsurprisingly, therefore, the administrator, as a person undertaking responsibility to act on behalf of the company and entrusted with the care of its property and its management, owes fiduciary obligations to it.[74] This means that the discretion to settle upon the objective for the administration — the exercise of which, as noted, will underlie and shape the character of the entire process of administration — is subject to the fiduciary duty to ascertain the statutorily defined circumstances which make one or other of the objectives the appropriate one to pursue.[75]

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[71] The following discussion draws on Armour and Mokal, "Corporate Rescue".

[72] That there is a statutory hierarchy of possible objectives is clear not just from the structure of the statutory text but also from the legislative history. During the passage of the Enterprise Bill, Ministers stated repeatedly in Parliament that the government wanted "to put company rescue at the heart of insolvency procedures because we want to save companies which have a decent chance of survival so that they are not driven to the wall unnecessarily"; Hansard, *HL Deb* 2 July 2002, Col 188 (Lord MacIntosh of Haringey).

[73] Paras 69, 67 and 68.

[74] A useful recent general description of the factors giving rise to fiduciary obligations may be found in *Peskin v Anderson* [2001] BCLC 372, [34] (Mummery LJ). That the administrator is a fiduciary is confirmed by *Oldham v Kyrris* EWCA [2003] Civ 1506; [2004] BPIR 165, [143] (Jonathan Parker LJ) (the case was decided under the old law, but its reasoning applies equally to the administration regime set up by the Enterprise Act).

[75] "The existence of the fiduciary duty on the part of trustees governing the exercise of their fiduciary powers requires trustees to inform themselves of the matters which are relevant to the decision", *per* Lightman J in *Abacus Trust Co (Isle of Man) Ltd v Barr* [2003] EWHC 114 (Ch), [2003] All ER (D) 79, [16], citing *Scott v National Trust for Places of Historic Interest or Natural Beauty* [1998] 2 All ER 705, 717. In the latter case, Robert Walker J also stated that such relevant matters "may not be limited to simple matters of fact but will, on occasion (indeed, quite often) include taking advice from appropriate experts".

Thirdly, therefore, the administrator must choose which objective to pursue *rationally*. Legislative history leaves no doubt but that the administrator's most fundamental decision has been designed to be subject to the rationality test.[76] This is in line with the position of other fiduciaries, and it is submitted that the courts will draw on the case law providing substance to the rationality test in the context of other fiduciaries to flesh out the standard by which the administrator's decision-making is to be judged.[77] It is clear that two competing values are at play here. First, the legislature intended that as far as possible, the courts should not be called upon to "second-guess the commercial judgment of administrators" willy-nilly, and that, "whenever possible, lawyers [should be kept] away from what otherwise would be more expeditious and business-friendly processes."[78] Second, however, there was the crucial concern — motivating this whole process of consultation and legislation — to save viable companies and businesses, to protect the interests of junior claimants, and to make the administrator accountable to them.[79] The way chosen to mediate between these values was the invocation of the rationality test. The requirement for the administrator to act rationally could be considered to be at the very heart of the new procedure, and coupled with the new statutory menu of objectives for administration, constitutes a significant shift in the way corporate rescue is conceived in this jurisdiction.

The rationality test serves the value of expert commercial decision-making by ensuring that what will matter is not so much whether the court considers that, on the basis of the evidence available at the time, it was reasonably practicable to achieve (a), etc, but rather whether the court considers that *a reasonable administrator* might have concluded this. The administrator's duty to select the correct objective is likely to be interpreted by courts so as to give considerable credence to the exercise of the administrator's business judgment. But the second value — that viable companies and businesses are rescued, the interests of junior claimants are protected and the administrator is made accountable to them — is also represented via the administrator's duty to act rationally.

In order to understand what the rationality requirement entails in this context, we may start by noting the close analytical connections between the administrator's fiduciary duty to act rationally, and the law governing judicial review of administrative ('public') action. The principles of judicial review specifically require the challenged public action to live up to the

[76] See e.g. Hansard,10 April 2002 : Columns 569-70 ("The word 'thinks' in those paragraphs means that the administrator will have to reach a considered view [about which objective to pursue]. In such situations, the administrator's decision would be subject to a rationality test by which it would be challenged if it could be shown that no reasonable administrator would have acted in such a way in those circumstances"); 29 July 2002 : Column 768 ("The present wording would mean that if the administrator's view were then to be tested, it would be subject to a 'rationality' test — that is, his decisions would be subject to successful challenge if it could be shown that no reasonable administrator would have acted in such a way in the particular circumstances of a case."), and 21 October 2002 : Column 1105 ("If necessary, we would expect the courts to assess whether the office holder, in this case the administrator, has been rational in his decision. We are not seeking to apply any other test.").

[77] .Several constituents have been identified of the defect now generically referred to as irrationality. For example, a decision by trustees is irrational if "it can be shown that [they] considered the wrong question, or that, although they purported to consider the right question they did not really apply their minds to it or perversely shut their eyes to the facts…"; *Dundee General Hospital v Walker* [1952] SC (HL) 78, 92, *per* Lord Reid, who goes on to say that in this case, "there was no true decision and the court will intervene".

[78] Hansard, 10 April 2002 : Columns 556-7, 21 October 2002 : Column 1105, etc.

[79] See e.g. Hansard, 10 April 2002 : Columns 566 and 570, and 29 July 2002 : Column 768, etc.

demands of rationality,[80] and the similarity between the public law and the fiduciary notions of rationality has been noted in the past. The Court of Appeal has remarked after a review of the relevant case law that it is "no coincidence that courts, considering the exercise of discretionary powers by those to whom such powers have been entrusted (albeit in different contexts), should reach similar and consistent conclusions, and should express those conclusions in much the same language".[81] Several first instance courts have expressed similar sentiments.[82] The courts have also been concerned, however, to distinguish the "much more developed"[83] body of judicial review principles grouped together as representing the requirements of rationality, from the principles applied to fiduciaries by private law.[84] One reason for doing so appears to be that the public law requirements of rationality are more demanding than their private law counterparts, so that judicial review principles *have to be* more developed than those applicable to fiduciaries in order to ensure that those more severe requirements have been satisfied. Two indicia have repeatedly been identified as marking the two areas apart from each other.[85] The first is the duty to give reasons, which plays a large and important role in ensuring the rationality of public decision making. Such a duty is said to have a role only in exceptional instances of the discharge of fiduciary obligations,[86] with at least one distinguished judge having commented upon the "widely-held view that trustees need not, and if well advised, should not, give reasons. There is probably a lot of good sense in that, in the general run of case".[87] The second difference is said to lie in whether there is a right vested in the person affected by a decision to be heard by the decision maker. While the person affected by a public decision usually has an *independent* right to be heard, the person affected by the decision of a fiduciary may be required to be heard *only insofar as* this is necessary for the fiduciary to become duly informed of matters relevant to the decision: "The difference between the public law and the trust approach is that the former focuses on the individual's opportunity to be heard before a decision, whereas the trust concept focuses on the information available to the person making the decision."[88]

Against this background, an analysis of the administrator's position proves instructive. Take first the duty to give reasons, which, as noted, is a particularly important aspect of the rationality test in the context of public decision making.[89] The administrator is unlike other fiduciaries in having a duty, not merely to *give* reasons, but to *explain* them. After he has picked the objective he will be pursuing, the administrator "shall make a statement setting out proposals for achieving the purpose of administration. [This] statement must, in particular… where applicable, explain why the administrator thinks that the objective mentioned in paragraph 3(1)(a) or (b) cannot be

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80 *Council of Civil Service Unions v Minister for the Civil Service* [1985] AC 374, 410-411 (HL) (Lord Diplock).
81 *Edge v Pensions Ombudsman* [1991] 4 All ER 546, 567-8.
82 See e.g. *Breadner v Granville-Grossman* [2001] Ch 523, [58]. See also Sir Robert Walker, "The Limits of the Principle in *In re Hastings-Bass (decd.)*" [2002] PCB 226, 227-228.
83 Ibid.
84 Lightman J has recently provided a useful discussion of the differences in the court's approach to granting remedies for the breach of fiduciary and administrative duties respectively; see *Abacus*, [29-30].
85 Systemised by Walker, "Limits", 228, who stated that the public law analogy for fiduciary decision making "cannot be pressed far in relation to" the two matters to be identified in the text.
86 Walker, *ibid*., notes that there might "perhaps" be such a duty "when pension fund trustees have to determine an issue as to a member's state of health".
87 Robert Walker J (as he then was) in *Scott v National Trust for Places of Historic Interest or Natural Beauty* [1998] 2 All ER 705.
88 *R v Charity Commissioners for England and Wales, ex parte Baldwin* (2000) 33 HLR 538, [49] (Jack Beatson QC, sitting as a Deputy Judge).
89 H. Woolf, J. Jowell and A.P. Le Sueur, *de Smith, Woolf & Jowell's Principles of Judicial Review* (London: Sweet & Maxwell, 1999), 12-019, including authority cited at fn 59.

achieved."[90] This requirement is, quite simply, the single most important element to ensuring both that (i) company rescue is put at the heart of the administration regime, and that (ii) the administrator is made accountable to all those interested in the debtor's undertaking. It is primarily through this explanation of his reasons that the administrator will show that he is complying with his duty to act in the interests of the creditors as a whole,[91] and not just, say, in the interests of the company's main bank. And it is primarily this explanation which renders meaningful the statutory right (particularly) of junior creditors to determine whether they should call the administrator to account as to what, as noted, is the most fundamental and far-reaching of his decisions.[92] The explanation must obviously consist (among other things) of those facts the existence of which persuaded the administrator not to pursue company or business rescue. So it would be inconceivable for Parliament to have allowed for the possibility that the whole panoply of statutory protections built around the meaningfulness of this explanation would be defeated by the simple expedient of the administrator making factual assertions whose truth or grounds could not then be examined by the court.

This is amply borne out by the statutory language. Notice that the administrator is not required to *give* or *disclose* or *state* or *reveal* why he thinks the company or the business cannot be saved, as the case might be. In fact, he is required to "*explain*" why he thinks thus. It is clear that "explain" is more demanding, in terms of the duty it places on the administrator, than "give" or "state" or "disclose" etc.[93] So exactly what does it mean in this context? Here are two possibilities. To explain his thinking might mean to make it plain or understandable, perhaps by avoiding jargon or technical terminology. Let me call this the 'explanation as clarification' view. Alternatively, explaining why the administrator came to think that the company or business were beyond rescue might require him to *account for his thinking*, to show what factors led him to think the way that he did. If these factors conflict — so that some count in favour of a quick liquidation while others argue for giving the company a second chance, say — then the administrator, on this view of "explain", would have to show what weight he gave to these various factors. And importantly, to explain the administrator's thinking in this sense requires him to avoid resorting to stock formulae, culled from his firm's 'Precedents' file, that do not connect sufficiently to the facts at hand in this case. This is the 'explanation as justification' view.

Now these two views of what it means to "explain" the administrator's thinking may not be mutually exclusive, and both might play a role. However, I suggest that the second sense of "explain" is more important in this context.[94] The administrator must not only make his decision

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[90] Para 49(2)(b).
[91] Para 3(2).
[92] Through Paras 74 and 75; see below.
[93] Compare '*State* the fundamental principles of the general theory of relativity' with '*Explain* the fundamental principles of the general theory of relativity'; or 'I will now *disclose* what the court held in this case' with 'I will now *explain* what the court held in this case'.
[94] Further, the administrator may need to refer to statistical tests of company 'survivability' or other technical judgements to *justify* his thinking which are not readily understandable, especially by non-experts. Here, the two notions of 'to explain' are in tension, and I submit — in view of the role the requirement to explain plays in the legislation, as explained in the text — that the need for the administrator to account for his thinking must outweigh the need for him to be easily understood. For notable examples of survivability (sometimes called 'bankruptcy emergence') tests, see e.g. Merxe Tudela and Garry Young, 'A Merton-model approach to assessing the default risk of UK public companies' (London: Bank of England Working Paper No. 194, 2003); Ran Barniv, Anurag Agarwal and Robert Leach, 'Predicting bankruptcy resolution' (2002) 29 Journal of Business Finance 497; S. Campbell, 'Predicting bankruptcy reorganization for closely held firms' (1996) 10 Accounting Horizons 12; M. Peel and N. Wilson, 'The liquidation/merger alternative — Some results for the UK corporate sector' (1989) 10 Managerial and Decision Economics 209;

rationally, he must also account for his "thinking". He must explain the facts, factors and considerations which, in his view, make his decision the appropriate one under the governing legislation. The legislation clearly seems to be shifting the burden of proof from any potential challengers to his decision having to demonstrate that he *failed* to comply with the requirements of rationality, to the administrator having to show that his decision, his "thinking", *succeeds* in being rational.

Consider now the question of whether those affected by the administrator' decision have the right to be heard. The administrator is clearly under no duty to consult creditors (or indeed members) before reaching his initial decision about which objective to pursue. However, he must then formulate proposals about how he intends to achieve his chosen objective. These must be placed before a creditors' meeting, and significantly, they must be accompanied by the administrator's explanation, if appropriate, of why he thinks one or both of the higher priority objectives cannot be achieved.[95] The creditors will of course have the opportunity to decide whether they consider his proposals acceptable, and in this regard, an important consideration will no doubt be whether they find his explanation of his choice of objective credible. The administrator may not put his proposal into effect unless it has been approved at the creditors' meeting.[96] The administrator, then, is different from other fiduciaries — and indeed from most public decision makers — in not only being under a duty to consult with those affected by his decision, but by also being subject, in his ability to put his decision into action, to a significant (though not absolute) veto by an appropriate majority of them.

Put these two factors together against the context set by the foregoing discussion and we can see that the administrator's duties to explain his reasons and to consult with those affected by his decision place him close indeed, on the continuum of duty-laden decision making, to those subject to the full-blown rationality requirements of public law. So the administrator's decision about which objective to pursue will have to be accounted for, and if necessary, defended by reference to standards that, on the above analysis, will not be that much less demanding than those to which public law subjects those within its domain. When one examines the statutory text, this conclusion is hard to avoid: objectivity veritably oozes from the statutory pores. Borrowing from the law governing public decision making, it is firmly established that where statute requires reasons to be given,

> those reasons must be both "adequate and intelligible". They must therefore both rationally relate to the evidence in the case, and be comprehensible in themselves. [A] decision may be struck down where an applicant can show substantial prejudice resulting from a failure on the part of the decision-maker to demonstrate how an issue of law had been resolved or a disputed issue of fact decided, or by "demonstrating some other lack of reasoning which raised substantial doubts over the decision-making process".[97]

Of particular interest in the present context will be the administrator's assessment of the facts upon which he decides which objective to pursue. Normally, courts are reluctant to interfere with

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Cornelius Casey, Victor McGee and Clyde Stickney, 'Discriminating between reorganized and liquidated firms in bankruptcy' (1986) 61 The Accounting Review 249.

[95] The administrator is not under a duty to call a creditors' meeting if he thinks the company has insufficient property to enable a distribution to unsecured creditors except of funds ring-fenced by virtue of s. 176A, or if he thinks neither of the two higher priority objectives can be achieved; para 52(1). However, he must summon a meeting if requested to do so by creditors holding at least 10% of the company's debt; para 52(2).

[96] Paras 49-56.

[97] Woolf, Jowell and Le Sueur, *Judicial Review*, 12-019, including authority cited in fns. 60-2.

the primary decision-maker's assessment of facts.[98] However, it is submitted that the administrator's findings of fact can be examined by the court on one of two bases. First, the statutory menu of options set out above might be interpreted as not conferring upon him the power to pursue objectives (b) and (c) "*unless*" or "*only if*" he "thinks" certain facts are present.[99] On this interpretation, the existence of these facts is a condition precedent to the administrator being able to pursue lower-priority objectives. For the administrator to choose to pursue lower priority objectives in the absence of these facts is for him to exceed his powers. It follows that the administrator's decision that these facts exist would be open to review by the court.[100] On the second and alternative interpretation of the statutory menu of options, the administrator has the power to pursue any of the objectives, but this power must be used for its proper purposes.[101] Now the administrator's finding and assessment of the facts is unavoidably central to the question how properly to exercise his power. And as I have argued above, ensuring the proper exercise of the administrator's power to select an objective for administration is quite crucial to whether the Parliamentary intention of enhancing rescue prospects for troubled companies and the office-holder's accountability would be brought to fruition. It is submitted, therefore, that this is a paradigmatic case where "Parliament intended [decision makers] rationally to relate the evidence and their reasoning to the decision… which they are charged with making."[102]

It follows that, on any available interpretation of paragraphs 3 and 49, the adequacy and cogency of the facts — as the administrator reasonably perceives them to be — that form the basis of his exercise of the power to pursue one of the objectives will be open to examination by the court. Also as part of the rationality test, in explaining his reasons for not pursuing one or other of the first two objectives, the administrator will have to show that he did not take into account something as a fact which was wrong, that he did not misunderstand the facts on the basis of which he reached his decision, that none of his decisions depends upon "no evidence", and that, taken as a whole, the evidence is reasonably capable of supporting his findings of fact.[103]

4. HOW WOULD THE ADMINISTRATOR CHOOSE THE OBJECTIVE OF ADMINISTRATION?

Given that the administrator is accountable regarding his choice of the objective to be pursued by the administration, how should he go about making this choice? Under paragraph 3, set out above, the administrator must choose whichever objective is in the best interests of the creditors as a group. Relating this to the discussion above, we can see that he may only resort to objective (c) — realising the company's assets for distribution to secured and preferential creditors — if the company is in economic distress. The administrator's basic aim here is to ascertain whether there is a going concern surplus, or in other words, whether the value of the company's business as a going concern is greater than the net realisable value of its assets if sold off piecemeal. If there is a going concern surplus, then objective (c) is out of bounds. Another way of saying the same thing is that economic distress marks the boundary between the first two potential purposes of administration (preservation of the company or its business as a going concern, respectively) and the third one (piecemeal liquidation of its assets). So before the administrator can fix the third

[98] *Ibid*., 4-055 to 4-067.
[99] That is, those facts set out in paras 3(3) and 3(4).
[100] See e.g. *R v Secretary of State for the Home Department, ex p Khawaja* [1984] AC 74.
[101] Determined, once again, by reference to paras 3(3) and 3(4).
[102] Woolf, Jowell, and Le Sueur, *Judicial Review*, p. 142, 4-067(6).
[103] Woolf, Jowell, and Le Sueur, *Judicial Review*, p. 461-2, 12-021.

objective as the one he will pursue, he must reach the conclusion that the company is in economic distress.[104]

So much for objective (c). But what about the first two objectives? How would the administrator decide whether properly to save the company or only its business as a going concern? In another paper, John Armour and I have analysed (a) the relative merits of pursuing either a reorganisation or a going concern sale, the main ways in which, respectively, a company or only its business might be rescued, and (b) the way that valid forfeiture clauses of the sort upheld in *Money Markets International Ltd v London Stock Exchange Ltd*,[105] will shape this decision.[106] In this paper, I want to discuss the importance — to the decision as to which of the first two objectives to pursue — of the administrator's assessment of the nature of the distressed company's management.

It was noted above that it would sometimes be essential to rescuing a company as a going concern to preserve in place at least some of its pre-distress managers (since that would be necessary to ensuring that the best value was derived from the company's assets). It has also been noted that the day to day affairs of most companies undergoing formal insolvency proceedings are run by those holding significant chunks of equity in them.[107] It is now suggested that this overlap of functions is in fact essential to the viability of some companies, especially smaller ones. Given perhaps the location or nature of their business, and ultimately in all cases, given their turnover, such companies would not be able to afford to hire outside managers. For them to be able to operate profitably, their shareholders would also *have to be* their managers. This is probably true of a majority of companies undergoing formal insolvency proceedings, and is likely to be true of most companies undergoing administration.[108]

These observations have important implications for the administrator's choice of objective. Barring the very unlikely situation where the company is restored to financial health during the currency of administration itself, the fulfilment of this objective would take the form of the conclusion of a CVA, scheme of arrangement or reorganisation. The company's creditors would be promised a payment on their claims (usually, one significantly lower than their face value) at a date some time in the future. Alternatively, they might be offered an equity stake in the reorganised company. The company existing bank (or another one[109]) might have to be persuaded to inject further funds to facilitate a reorganisation. Other counter-parties might need to be convinced not to insist on protective measures (demanding cash on delivery, paying lower prices for the company's goods to discount for the uncertainty that it would fulfil its warranties or be able to provide replacement parts, etc.) in their dealings with the company. All of this turns, very

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[104] It should be emphasised once again that this is meant to apply to economically distressed companies which are or are likely to become unable to pay their debts as they arise. In other words, economic distress is a necessary though not a sufficient reason for the company's assets to be liquidated piecemeal. The reasons are explained in a lengthy footnote above.

[105] [2002] 1 WLR 1150.

[106] Armour and Mokal, "Corporate Rescue".

[107] Recall the evidence discussed in a footnote above, indicating that most companies undergoing formal insolvency proceedings are small and closely held.

[108] Ibid. It is in fact one of the stated aims of the new legislation to draw closely-held companies to use the administration procedure; see e.g. Mr. Douglas Alexander, Minister for E-Commerce and Competitiveness, Hansard HC committee, Column Number: 549: "we want to encourage smaller companies, many of which will have owner-managers, to use the procedure as a rescue vehicle at the early stages of financial difficulty".

[109] See Armour and Mokal's discussion of the administrator's duty in searching for funding in "Corporate Rescue".

crucially, on whether the administrator has confidence in the competence of the company's post-administration management, and on whether he can bring these other parties to share that confidence. After all, the management would be responsible (perhaps subject to oversight by a CVA supervisor) for delivering on all the promises made to procure a CVA, scheme or reorganisation.

It follows that where saving the company would mean retaining (some of) the pre-administration shareholder-managers in place, an important reason that might lead the administrator to think that achievement of this objective would *not* be reasonably practicable[110] would be that he did not have confidence in the competence of the managers.[111] In addition, saving the company would not then achieve a better result for its creditors than they would under management more capable of delivering the performance required to make a success of the CVA, scheme or reorganisation. The administrator would then be justified in moving down the hierarchy of objectives and attempting only to save the company's business (by arranging a going concern sale).

The factors leading the administrator to lack confidence in the management would be immensely varied. He might feed off the experience of the company's main bank in dealing with the managers in the past. He would form his own impressions during his visits to the company's premises and his meetings with key functionaries, including of course the managers themselves. However, it is possible to locate certain generic signs that might allow him to conclude, in a way defensible at law, that the pre-administration management does not deserve confidence.

First and most obviously, managers would not be capable of being trusted if, on the eve of administration, they operated in disregard of creditors' interests.[112] For the administrator to find evidence of fraudulent or wrongful trading would, needless to say, require him to consider arranging for appropriate legal action to be brought against them.[113] Even if the evidence possessed by the administrator does not meet the legal standards required to establish either of these statutory wrongs, however, the administrator might still come to think that he could not in good faith advise creditors and other counter-parties to place their confidence in the managers.[114] So for example, the managers might have manipulated the company's accounts as it hurtled towards administration. They might have tried to factor debts, sold and then leased back some of their own equipment, or borrowed indirectly (via associated companies or joint ventures etc.), all in an effort to conceal how much the company had borrowed. They might have tried to stave off

[110] Para 3(3)(a).
[111] This is consistent with evidence as to the current practice of IPs; see e.g. Gary Cook, Naresh Pandit, David Milman and Carolynne Mason, *Small Firm Rescue: A Multi-Method Empricial Study of Company Voluntary Arrangements* (London: Centre for Business Performance, 2003), 22.
[112] Evidence about the current process of acquiring creditor approval for a CVA is consistent with this: "some creditors will be beyond convincing [as to the desirability of entering into a CVA] where they believe the directors to have been feckless or dishonest, for example, the persistent non-payment of PAYE and VAT, one of the Voluntary Arrangement Service's over-riding reasons not to support a CVA"; see Cook *et al*, *Small Firm Rescue*, 14. See also ibid., at p. 33: "creditors are willing to forgive debt in situations where they believe the company directors have been straight in their dealings with them and have not been the cause of their company's problems through deceit or recklessness." For further evidence, see pp. 37, 39 and 40.
[113] IA ss. 213 (fraudulent trading) and 214 (wrongful trading) restrict the availability of these actions to a liquidator. For an examination of the latter, see e.g. Mokal, "An agency cost analysis of the wrongful trading provisions" [2000] CLJ 335.
[114] The discussion in the remainder of this section draws on and adapts the thoughtful work of John Argenti; *See Corporate Collapse — The Causes And Symptoms* (London: McGraw-Hill, 1976) and *Predicting Corporate Failure* (London: Institute of Chartered Accountants in England and Wales, 1984).

the appearance of insolvency by causing its accounts to give inflated values to intangible assets (goodwill, brand names and other intellectual property, etc.). Or they might have inflated the company's sales or its receivables, or had its non-real estate assets revalued upwards. Finally, they might have 'left cheques in the drawer', attempting to reduce the appearance of the company's liabilities while keeping its overdraft within limits. And so on. An appropriate combination of some of these factors might incline the administrator towards thinking that the company's creditors could not reasonably be asked to believe that the managers would not resort to these tactics once again, were they to perceive that they were unable to fulfil the promises concerning the company's performance made to procure a reorganisation. It would then follow that the creditors as a group would be better off if the company were not saved.

Second and having gained a thorough familiarity with the company's history, the administrator might develop concerns about the structural profile of its senior management team. The company might be dominated by one person — the managing director or controlling shareholder — who is inflexible in his views and not amenable to advice from colleagues. Or the team might be unbalanced, consisting predominantly of optimists (pessimists), or of extroverts (introverts), or of 'salesman types' ('accountant types') or of 'entrepreneurs' ('organisation types'), etc. So the balance of personality types or skills required to deliver on the administration promises might be lacking.[115] There might be too much friction between the management and workforce, and this might be leading to a high turnover of staff. This would drive away experienced staff with company-specific skills. Or the management might be excessively cosy with the workforce, many of whom might be so entrenched as to be unable to bring about much needed change. And especially in family-run companies, there might be problems in ensuring continuity of good management, with unsuitable junior family members automatically next in line for imminent succession, or on the other hand, no potential successors at all. Once again, an appropriate combination of some or all of these factors might contribute to the administrator's thinking that the company is not viable.

Finally, the existing management's relationship with its main creditor or other potential lenders would be an important consideration. If in the run-up to administration, lenders were faced with late or inaccurate accounts, an absence of company-provided information, a difficulty in tracking down important management figures, misuse of the agreed overdraft or violations of it, or returned cheques, it would be unsurprising if they lost confidence in the managers. Not only will this impact on their willingness agree to a reorganisation or CVA by countenancing the perpetuation of the management in the post-administration period. It might also, crucially, convince them not to pledge further funds to the company. In this case, attempting to save it might well not be practicable.[116]

A reasonably competent administrator, faced with some of the factors just discussed, might justifiably come to think that it would be more worthwhile attempting to preserve the going concern value of the company's business and not the company itself. It is important to note, however, that in some cases, a business might be salvageable *only* if it retains key members of its pre-administration managerial team. Once again especially in the small-company sector, a manager might have highly specialised skills or other attributes essential to the survival of the business (e.g. familiarity with local suppliers who would not offer to others the discounts they provide to him, or the trust of local customers who would abandon the business in question in

[115] In compliance with the rationality test, the administrator's judgements on this count would have to have some reasonable grounding in the available evidence.
[116] It is important to emphasise, however, that this observation is subject to the administrator's duty to consider alternative sources of funding; see Armour and Mokal, "Corporate Rescue".

favour of the nearby supermarket if he were to leave). One possibility here might of course be to acquire new equity holders and to retain the key manager in place only *qua* manager. However, suppose that a business thus symbiotically linked with key managers also falls in the category described above — namely, one which is not viable except by concentrating the role of (main) manager and (main) shareholder in one and the same person. In such a case, the objective of saving the business cannot be cleaved apart from trying to save the company. So if the administrator found himself thus confronted both by a business dependent on the shareholder-managers, and shareholder-managers whose competence to lead the business through the post-administration period he has reason to doubt, he would naturally have to assess and compare the expected costs and benefits of retaining the managers' services from the point of view of the company's creditors as a whole.

5. THE ADMINISTRATOR'S INCENTIVES AND CHALLENGES TO HIS DECISIONS

The Enterprise Act provides three routes through which the administrator's decisions might be challenged. Paragraph 74(1) empowers any creditor or member of the company to apply for relief on the basis that the administrator has acted or is acting or proposes to act so as unfairly to harm his interests. Paragraph 74(2) provides any creditor or member with the power to challenge the administrator for not performing his functions with reasonable speed or with reasonable efficiency. And paragraph 75 empowers the court to examine the administrator's conduct for misfeasance. My interest is in the first two routes for challenging the administrator, and my purpose is to provide an explanation of the sort of factors which might lead a creditor or member to question whether the administrator was complying with his duties.

I suggest that there are three quite crucial observations (hereafter, the 'motivational factors') which provide the background against which the three duties are to be understood. First, an overwhelming majority of administrators could be expected to be appointed by the distressed company's bank. It has been argued elsewhere that it is in the interests of *everyone* interested in the debtor company's business both for the debtor's main bank to be given the right to appoint an administrator, and for it to be able to do so out of court.[117] However, it should be obvious the benefits from allowing this to happen come at a cost. As noted above, in a substantial proportion of cases, the bank would be oversecured or would have alternative, cheaper means to ensure repayment (e.g. enforcing directors' guarantees) not requiring the maximisation of the value of the debtor's estate. The bank would not therefore be the company's residual claimant, and there would be a divergence of interests between it and the actual residual claimants (shareholding directors who have also lent money to the company, Crown, employee- and trade creditors, etc). What is problematic here is that IPs would rightly expect most of their work (i.e. future appointments as administrators) to come from the banks. They would thus have strong incentives, in situations where the bank's interests diverge from those of other creditors, of developing a reputation for favouring the former.[118]

The other two reasons would, I hope, prove to be only transitional ones. The IPs who are appointed administrators would of course be the very individuals who have hitherto been acting as receivers. This means they would have been socialised in a milieu where the interests of secured creditors — mainly banks — reigned supreme. There would therefore be a tendency for the professional judgements of these IPs to be shaped by those interests. In the transitional period

[117] Mokal, 'Floating charge', Section III; see also Armour and Frisby, "Rethinking Receivership".
[118] In the context of receivership, this problem is discussed by David Milman and David Mond, *Security and Corporate Rescue* (Manchester, Hodgsons, 1999). See also Armour and Mokal, "Corporate Rescue".

as the new law 'beds down', the inclination of these IPs would be to continue acting as they have done before, *qua* receivers. Once again, therefore, in situations where the bank's interests diverge from those of junior claimants, the decisions and actions of the IP — now under a duty *qua* administrator to act in the interests of *all* the creditors — would tend to be inapposite. And finally, there is anecdotal evidence of some feeling amongst both IPs and the lawyers who generally act for banks, that the new law would not make any noticeable difference, that the new administration is nothing but administrative receivership disguised so as to make it more generally (and internationally) acceptable. This 'business as usual' view is of course highly cynical and quite unsustainable, both because it is based on an ignorance of (or perhaps a refusal to acknowledge) the social harm done by receivership (as identified above), and because it is premised on regarding as meaningless the extensive consultation and legislative process from which the new administration has emerged.[119]

Given these motivational factors, I suggest that compliance with the duty to act in the interests of all the creditors as a group, and the duties to act with reasonable speed and efficiency would have to be carefully monitored by the courts, especially during the initial years after the introduction of the new procedure. If the courts are able, through their approach to the interpretation of these duties, to send the correct signal sufficiently early on about the way in which administration *must* be different from administrative receivership, the chances that the legislation would achieve its stated objectives would be greatly improved. The amount of future litigation could also then be expected to be low.

Let us start with the duty to act in the interests of the creditors as a whole. This is modelled on the duty of directors of a solvent company to act in the interests of the company as a whole, a duty the scope of which is well-understood as determined by what *the directors think* — and not what the court thinks — to be the interests of the company.[120] Of course, if a decision is taken in bad faith, or is clearly irrational — such that no reasonable director could have thought it to be in the interests of the company — then this will raise an evidential presumption that the directors did not *in fact* consider it to be in the interests of creditors. Presumptively, this should hold for administrators as well.

In the administration context, however, the motivational factors sketched out above provide reasons for going further. The board of a solvent company consists of, or is chosen[121] or at least not disapproved by, (a majority of) the shareholders (the residual claimants), who retain the power to remove directors.[122] On the other hand, administrators will mostly be appointed by banks (which, as discussed above, are often not the residual claimants), and as officers of the court, may not be removed except by court order.[123] The influence of the interests of (at least a majority of) the solvent company's residual claimants over directorial decision making, derived from the shareholders' ability to select or at least disapprove of the board, does not therefore find an analogue in administration. The *bank* would of course enjoy the advantages provided by, *inter*

[119] For what it is worth (over and above the very fact that the new legislation exists, was put on the books after a long process of consultation, and emphatically aims to bring about change to the way things were under receivership), Lord McIntosh of Haringey noted on behalf of the government that "it simply was not true" that is would be "business as usual for receivers turned administrators", that administrators would not continue in the footsteps of receivers by continuing "to sell off assets in a quick and dirty sale simply to cover the secured creditor's debts [while] justifying such actions as being better for the creditors in the short term"; 21 Oct 2002: Column 1101.
[120] *Re Smith & Fawcett Ltd* [1942] Ch. 304.
[121] See Companies (Tables A to F) Regs. 1985, Table A, art. 73.
[122] Companies Act 1985, s. 303.
[123] Para 88.

alia, its ability to offer or withhold future appointments to the IP. So the IP's interests will lie with the bank's interests. It follows that the duty of impartiality inherent in the obligation to act in the interests of creditors as a whole will be a main bulwark for *junior* claimants against IP partiality in favour of the bank.

We can expect the problem to be most acute when the bank is marginally oversecured or marginally undersecured, i.e. when the value of the collateral (taking into account any additional security also available to the bank) just about covers the bank debt (and administration costs) or falls just short of doing so. Now if the company or its business are essentially viable, the administrator's duty would be to seek to preserve them. However, the bank — worried about the risk of deterioration in the value of the collateral[124] — would prefer an early sale of the assets. And due to the motivational factors, the administrator would tend to favour the bank. The conflict here would revolve around (a) the objective the administration should pursue, (b) the time it should last, and (c) the level of effort the administrator should put into finding ways of rescuing the company or business as a going concern. Where the bank is marginally over- or undersecured, then, the courts will have reason carefully to scrutinise these three types of decision, keeping in mind the tendency for administrator bias in favour of whichever course of action most quickly realises the value of the bank's collateral.

The duty to act reasonably quickly and efficiently will, prima facie, require the administrator to perform his functions as quickly and efficiently as is practicable under the circumstances *as he reasonably believes them to be*.[125] Efficiency here evidently means cost-effectiveness.[126] Crucially, however, the credibility of the administrator's claim that he reasonably believed some or other circumstances to exist must once again be assessed in the context set by the three motivational factors sketched out above. Where the bank is undersecured (again taking into account *all* types of security available to it), it would of course wish to ensure that the administrator spent only that time, undertook only those tasks, and incurred only those costs, which were reasonably necessary for the achievement of the purpose of administration. And the administrator, with an eye to future appointments being sent his way, would have an incentive to do likewise. The situation would change, however, where the bank is *significantly* oversecured. Now the bank would have less reason to fear an administration lasting longer than it needs to, and less reason to prevent the administrator engaging in unnecessary activity and incurring unnecessary costs. In either case, the bank would expect its collateral to continue to cover its debt. Just as they are in the receivership system, the costs of this wastefulness would be borne by junior claimants. It follows that in situations where the bank is significantly oversecured, the courts would have to scrutinise the administrator's behaviour keeping in mind this tendency towards delay and the inflation of costs.

I suggest that the courts will be guided here by the principle that the administrator is "for all practical purposes a trustee of the monies forming part of the insolvent estate and is required to be able to justify as prudent every decision made as to its expenditure and to prove and justify every

[124] And perhaps in the surety-directors' resources, who would have an incentive precisely in this situation (viz., when they judge the company to be viable) to lend more to the company.

[125] "The duty of a given administrator is clearly to be interpreted in the light of what is reasonably practical in the particular circumstances of a case"; Lord McIntosh of Haringey, 21 Oct 2002: Column 1117.

[126] While efficiency has several other technical meanings (discussed in R. Mokal, "On Fairness and Efficiency"), legislative history provides no indication that the legislature intended to invoke anything but the ordinary, everyday understanding of this term.

penny spent."[127] The foremost test will be that of cost-effectiveness itself. Where the undertaking of a procedure or its costs are challenged, the courts would ask how the expected costs (in time and money) of undertaking a procedure compare with the value of its expected benefits (whether it be the expected rescue of a company or its business or the expected increase in recoveries for claimants). Both sides of this equation would be solved by reference to evidence that would reasonably have been available to the administrator at the time that the procedure was undertaken.

In the context of a challenge to the costliness of a certain procedure, when judging the administrator's actions in light of the duty of speed and efficiency, the appropriate test would not be what the bulk of administrators would do in similar circumstances. The reason is obvious: given the structure of administration, the perverse incentive to incur delays and (thus or otherwise) to inflate costs can be expected to be endemic, and not merely restricted to some individuals or firms.[128] Further, the legal obligation is for the administrator to act reasonably quickly and efficiently. It is not for him to act as other IPs would have acted under the circumstances, nor to act in a way that would be *considered* quick or efficient by other IPs. It goes without saying that in taking its decisions, the court would be assisted by, among other things, expert evidence from other IPs about what they would regard as appropriate. However, the point would be to examine why a particular procedure was adopted when a less expensive one was available, say, or why a certain type of service was charged at a particular rate when an analogous service would cost less in a context where the person hiring the relevant service would also expect to pay for any wastefulness on the service-provider's part. Compendiously put, for the duty to act efficiently to be meaningful in the contexts where it would be needed the most, it would have to be tested not by 'norm-based' standards (i.e. by what in normal practice is regarded as appropriate) but by 'criterion-based' ones (i.e. by asking why this procedure was performed at this price in these particular circumstances).[129]

6. CONCLUSIONS

It has been argued that the Enterprise Act 2002 has significantly changed the way those dealing with distressed companies are required to behave. The motivation for this change lies in the ways in which administrative receivership was destructive of social value (in terms of unnecessary job losses and other resource misallocations). Three such ways were identified, all linked with the fact that receivership ties the office-holder's duties to the interests of the debtor's bank. This is undesirable because the bank (a) is usually oversecured and thus has little incentive, once receivership is underway, to ensure that financially distressed companies would not be wound up or their businesses not liquidated, (b) has the benefit of directors' guarantees, which weakens its incentives to ensure the maximisation of the value of the company's business even in those cases where its proprietary security is insufficient to cover what it is owed, and (c) has little incentive in either of these cases to control the costs of receiver wastefulness or negligence. These problems are compounded by the fact that the supply side of the market for banking services to SMEs is significantly monopolistic.

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[127] G. Lightman, "Office Holders' Charges: Cost Control and Transparency" (1998) 19(3) Company Lawyer 72, 73, explaining (extra-judicially) the effect for insolvency office-holders of Ferris J's judgment in *Mirror Group Newspapers plc v Maxwell and others (No 2)* [1998] 1 BCLC 638.

[128] Because when the bank is significantly oversecured, *all* administrators, no longer worried about harming their reputation with it, would have a tendency to suffer these perverse incentives.

[129] This analysis is consistent with the systematic and more detailed discussion of the ways in which the courts might require administrators to show that they have complied with their duty to act with reasonable speed and efficiency in G. Lightman, "Office Holders' Charges", and G. Lightman, "The Challenges Ahead", 117-118.

In order to remedy these defects, Parliament has imposed upon the administrator the duty to attempt a company or business rescue, as appropriate, if either one is in the interests of the creditors as a group. This duty is an objective one, is subject to the rationality test, and requires the administrator to account for his decision about which objective is to be pursued. The paper provided an understanding of company rescue consistent with the explicit text and legislative history of the statute, and discussed the importance to the administrator's decision about whether to attempt such a rescue of the quality of the company's pre-distress management.

Finally, the mechanisms provided by the statute for an aggrieved party to hold the administrator to account were discussed. The paper highlighted the importance of three factors. (a) Most administrators will be appointed by the company's main bank. (b) The Insolvency Practitioners who act as administrators would be the same individuals who have acted in the past as administrative receivers. (c) There has been a paucity of understanding amongst the professionals, lawyers and accountants, about the significance of the changes brought about by the Enterprise Act. The administrator's statutory duties to act in the interests of all the creditors as a group and to act with reasonable speed and efficiency were examined in the light of these observations.